



The Economic Forecast

The recession of 2001 was one of the most shallow and short-lived in U.S. history, although the collapse in equity prices on Wall Street and the shock from the terrorist attack of September 11, 2001 certainly compounded the underlying weakness in the economy. The national economy began to stage a weak recovery in the fourth quarter of calendar year 2001.

The predominance of the high-tech industry in Virginia, previously a stabilizing force and the primary driver of growth, adversely affected the state's economy in fiscal year 2002. Virginia was significantly affected by the implosion of the high-tech and telecommunications industries and has still not recovered well into fiscal year 2003, as the state's economy continues to shed jobs.

Virginia's economic performance has a direct impact on the revenues the Commonwealth receives and the services that are demanded. As economic growth slows, the Commonwealth experiences slower growth in revenue collections and an increase in the demand for services such as unemployment compensation and Medicaid.

The national economy began a weak recovery in fiscal year 2002

The U.S. economy began a weak recovery in fiscal year 2002. Employment registered small increases and consumers continued spending. The direct effects of the terrorist attacks of September 11 were not as large as they could

have been, thanks to federal fiscal and monetary policy stimuli, automotive sales, and lower oil prices. Some of the economic developments during fiscal year 2002 include:

Growth in U.S. Gross Domestic Product (GDP) slowed considerably. The value of all goods and services produced within the U.S., adjusted for inflation, grew at 0.8 percent in fiscal year 2002. Growth in total personal income was 2.1 percent, while wages and salaries increased by 0.7 percent.

Consumer spending saved the U.S. economy. Consumer spending experienced solid growth in fiscal year 2002, increasing by 2.7 percent. Only the resiliency of the consumer sector kept real GDP growth from falling into negative numbers.

Job losses exceeded the forecast. Total non-agricultural employment in the U.S. declined by 0.8 percent during fiscal year 2002. Feeling the brunt of the weak economy were the manufacturing sector, the construction sector, and the transportation, communications, and public utilities (TCPU) sector.

U.S. economy falls into recession

	Fiscal Year 2002		2002-2004 Biennium	
	Forecast	Actual	2003 Forecast	2004 Forecast
Real GDP	(0.5)%	0.8%	2.8%	3.9%
Total Employment*	(0.5)%	(0.8)%	0.1%	1.8%
Unemployment	5.7%	5.5%	6.1%	5.9%
CPI	1.9%	1.8%	2.3%	2.9%

*Total nonagricultural employment. Figures represent percent change over previous year, except unemployment rate, which is a percentage. Data based on the September 2002, DRI.WEFA standard forecast. Source: Department of Taxation

Inflation was slightly lower than expected. The actual increase in the consumer price index (CPI) was 1.8 percent, very close to the forecast of a 1.9 percent increase.

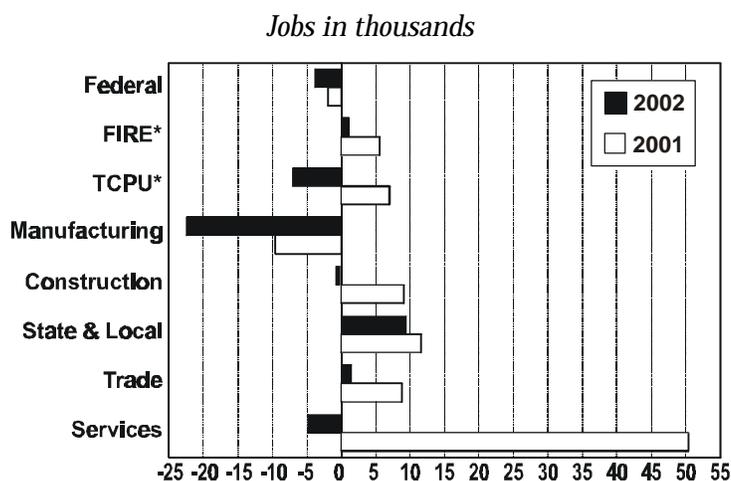
The Federal Reserve Bank was aggressive as the economy slowed. Following the terrorist attacks, the Federal Reserve Bank cut interest rates several times to lower costs for firms to invest in capital stock and help spur economic growth. It set the federal funds rate target at 2.5 percent, the lowest rate in a generation.

U.S. economic recovery continues in fits and starts

At the November meeting of the Governor's Advisory Council on Revenue Estimates, the consensus economic forecast was for a weak expansion. Highlights of the economic outlook for the next two years include:

- ▶ Real Gross Domestic Product (GDP) growth is expected to increase by 2.8 percent in fiscal year 2003 and 3.9 percent in fiscal year 2004.
- ▶ Job growth is expected to be flat in fiscal year 2003 and increase by 1.8 percent in fiscal year 2004.
- ▶ Real consumer spending should continue its steady pace over the next two fiscal years, increasing by three percent and 2.9 percent in fiscal years 2003 and 2004, respectively.
- ▶ The continued slump in business investment has been largely responsible for the weakness in the economy. The rising supply of inactive and underused capital will be a damper on GDP growth for several years.
- ▶ Despite highly stimulative monetary and fiscal policies, price inflation should remain moderate over the forecast horizon.
- ▶ In November, the Federal Reserve Bank cut interest rates by half a percentage point, and signaled that rates would be maintained at this level into the near future.

Most employment sectors suffered job losses in fiscal year 2002



*Finance, Insurance, and Real Estate (FIRE). Transportation, Communication, and Public Utilities (TCPU). Source: Department of Taxation.

Virginia's economy much weaker than expected in fiscal year 2002

Like the nation, the Virginia economy experienced a recession and remains sluggish with continuing job losses. Economic growth in Virginia was weaker than expected in fiscal year 2002, with employment and income growing well below forecasted growth rates.

The Virginia economy suffered net job losses for the first time since the early 1990's recession. Nonagricultural employment fell by 0.8 percent, well below the official forecast of 0.5 percent growth. Particularly hard hit were the manufacturing and telecommunications sectors. The statewide unemployment rate rose to 4.1 percent, 0.6 percentage points above the official forecast.

Here is a look at regional employment in Virginia during fiscal year 2002:

Northern Virginia. Northern Virginia, home to most of Virginia's high-tech industries, experienced a 0.1 percent decline in employment. Northern Virginia lost about 15,900 jobs in the high-tech business services sector. In addition, the region lost about 2,800 jobs in the telecommunications sector.

Richmond/Petersburg. In line with statewide growth, employment in the Richmond-Petersburg area declined by 0.8 percent in fiscal year 2002, a loss of about 4,400 jobs. Most of the losses were in the manufacturing sector.

Norfolk/Newport News/Virginia Beach. Employment in the Norfolk-Newport News-Virginia Beach area declined by 0.1 percent. The Tidewater area lost about 400 net jobs.

Balance of the state. Employment in the balance of the state fell 1.9 percent in fiscal year 2002, declining by 20,700 jobs. A loss of 14,300 manufacturing jobs accounted for most the drop.

Virginia's economy expected to experience shallow recovery in fiscal year 2003

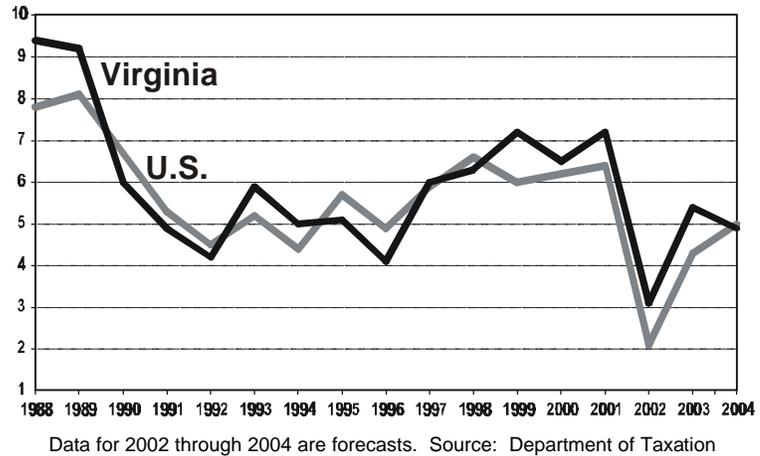
Although manufacturing remains in a slump and the previously stabilizing high-tech industry has faltered, Virginia's employment diversity still provides somewhat of a buffer. The federal government and its contractors continue to provide economic stability as the war on terrorism benefits Virginia through increased government spending. Virginia's tourism industry also continues to thrive. Finally, even though the high-tech bubble has burst, the buildup established a fundamental base of technological know-how, physical structures, and human capital that should benefit future growth.

Here is a look at what economists are predicting for Virginia in fiscal year 2003:

- ▶ Virginia's personal income growth is expected to exceed the nation's over the major-

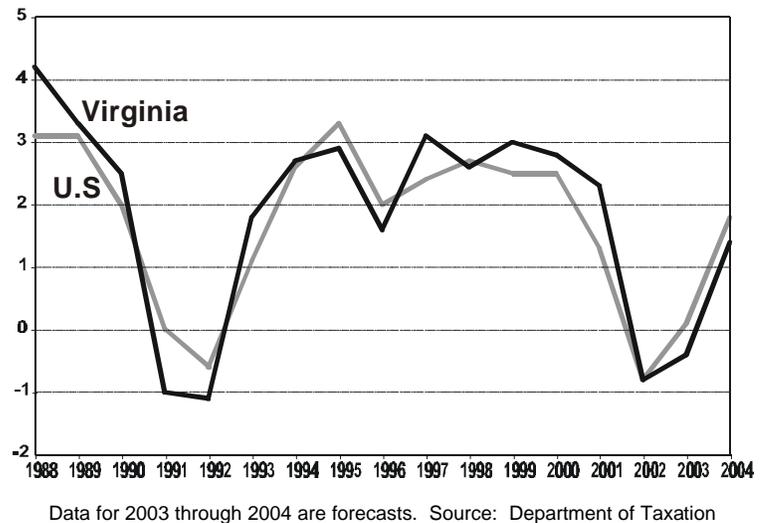
Personal income growth to slightly exceed the nation's over the forecast horizon

Percentage growth in personal income



Virginia employment growth to lag the nation's

Percentage growth in nonagricultural employment



ity of the forecast horizon, with growth of 5.4 percent in fiscal year 2003. Growth in wages and salaries is expected to nearly double the pace of fiscal year 2002, growing at 3.2 percent.

- ▶ In fiscal year 2003, Virginia is expected to experience four consecutive quarters of negative employment growth. Employment

is expected to decline by 0.4 percent in fiscal year 2003. Growth in fiscal year 2004 will be markedly better, with an expected growth rate of 1.4 percent. The declines are most severe in the manufacturing, construction, and TCPU sectors.

- ▶ Services employment is forecast to improve, growing at 0.8 percent in fiscal year 2003.
- ▶ Construction employment is expected to decline sharply in fiscal year 2003, falling by three percent. However, the construction sector is expected to rebound considerably in fiscal year 2004, growing by 1.4 percent.
- ▶ Employment growth in wholesale and retail trade is expected to be nearly flat in fiscal year 2003.
- ▶ Virginia's manufacturing sector will continue to shed jobs. Employment is expected to decline by 4.1 percent in fiscal year 2003.

Predictions for the near future

In summary, Virginia experienced a recession resulting in major job losses and subsequent declines in income. The near-term outlook is for continued sluggish economic growth. Employment is expected to decline for four additional quarters but personal income is expected to improve from its fiscal year 2002 pace.